Sysco Corporation SYY

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Analyst Note 02-02-2009

While Sysco's SYY second-quarter earnings clearly indicate that the firm is not immune to rapid food inflation and deteriorating macroeconomic conditions, we're holding tight on our fair value estimate for the firm, as results thus far are trending in line with our expectations. For the quarter, total sales fell 1% over the year-ago period, as volume declines more than offset the effects of food inflation. According to management, food cost inflation amounted to 7% as compared to the year-ago quarter--a number that remains elevated. However, volumes slipped at a greater rate, and we believe this volume decline is most likely due to price-conscious consumers pulling back on spending at restaurants, where Sysco derives two thirds of its sales.

Excluding costs related to Sysco's corporate-owned life insurance program and its exit from a multiemployer pension plan, operating margins grew 20 basis points to 5.1% of sales, primarily reflecting efficiency improvements the firm is realizing. Also, Sysco now expects that capital expenditures will be about $100 million less than its original projections for the year. We believe that this reduced amount of capital spending, as well as its intentions to limit share repurchase activity throughout the remainder of its fiscal year, is a sign that the firm is building up a cash reserve in anticipation of acquisition opportunities. In our opinion, while Sysco is being impacted by the weak economy and high food inflation, its smaller competitors are under greater pressure and could become acquisition targets.

Looking forward, we expect fiscal 2009 to be a tough year for Sysco. Given that a majority of Sysco's sales are from the restaurant space (a sector that is feeling the sting from consumers tightening their belts), sales for Sysco could be constrained over the near term. That said, we believe that Sysco will ultimately weather the current storm better than its competitors due to its unparalleled scale, the breadth of its products and services, and its continued focus on reducing costs.

Thesis 01-14-2009

Sysco is not immune to the barrage of challenges created by food inflation and deteriorating economic conditions, but we believe the firm will weather the current storm better than its competitors due to its unparalleled scale, the breadth of its products and services, and its continued focus on reducing costs.

Sysco is the leading food-service distributor in the United States and Canada, with about 15% share of this estimated $200 billion to $300 billion market. While food distributing is generally a low-margin, capital-intensive business, Sysco's economies of scale have allowed it to consistently post returns on invested capital well beyond our estimate of the firm's cost of capital. Through more than 145 acquisitions since its founding about 40 years ago, the firm has developed a wide-reaching distribution network over which

Morningstar Rating
★★★★★

Stock Price
As of 02-02-2009
$23.54

Fair Value Estimate
$35.00

Consider Buying
$24.50

Consider Selling
$49.00

Fair Value Uncertainty
Medium

Economic Moat
Wide

Stewardship Grade
B

Bulls Say

- Sysco is the largest food-service distributor in North America with 15% share of the market, followed by U.S. Foodservice with 10% and Performance Food Group with 3%.
- The firm's supply-chain initiatives, which include building nine distribution centers, should allow Sysco to consolidate inventory and negotiate more-favorable procurement terms with suppliers.
- Because of its continued emphasis on stringent cost management, Sysco has realized returns that are about three times the level of its peers.
- Although operating margins only amount to about 5% of sales, Sysco has generated returns on invested capital (including goodwill) or approximately 25%.
- We are encouraged by the diversity of the firm's customer base, as no single customer accounts for more than 5% of Sysco's consolidated sales.

Bears Say

to spread its high fixed costs that no other competitor has been able to replicate.

We are also impressed by the breadth of Sysco's products and services. The firm distributes more than 300,000 traditional food and nonfood products, serving 400,000 customers in various industries and has expanded into other profitable niche segments, such as health care, education, and lodging. In an effort to solidify is customer relationships, Sysco has made it a priority to consult with its clients on how they can drive sales and minimize costs (an advantageous undertaking, given that approximately 80% of its sales are derived from smaller customers).

Despite its positioning as a low-cost provider, Sysco is keenly focused on trimming additional costs from its already-lean operating structure. For instance, Sysco is working to reduce the complexity of its supply chain by more efficiently routing its deliveries, as well as building several redistribution centers. The firm is already realizing some initial benefits from these efforts. More specifically, in the first quarter of its current fiscal year, Sysco noted that its fuel gallon usage had fallen by 8%, while the number of cases it delivered per trip had increased 3%--a notable accomplishment in our opinion.

Despite these competitive advantages, it is not all wine and roses for Sysco. As price-conscious consumers rein in their spending in this difficult macroeconomic environment, Sysco's volumes will likely suffer, particularly in the restaurant sector. Further, we believe food costs will remain elevated for the foreseeable future. We recognize that Sysco faces some major head winds in the near term, but we believe the firm's expansive distribution network and its leading market position will enable it to continue generating strong cash flows and outsized returns for shareholders over the longer term.

Valuation

Our fair value estimate for Sysco is $35 per share. We expect that weakening economic conditions will weigh on the firm's near-term sales, as food inflation is countered by volume declines. We believe sales growth will slow to around 3% annually over the next two years before returning to 5% annual growth longer term. Despite elevated food and fuel expenses, we do not expect that Sysco's consistent profit generation will significantly falter. We believe the firm should continue delivering operating margins of around 5% of total sales over the next five years. We have not forecast any acquisitions (despite the firm's acquisitive nature in the past), even though we anticipate that Sysco will make some smaller bolt-on acquisitions from time to time. We don't expect these additions to move the needle significantly on our valuation, given that over the past five years, less than 1% of its sales growth resulted from acquisitions.

Risk

Risks to our valuation for Sysco include economic head winds and food inflation. Given that about two thirds of Sysco's sales result from the restaurant space (a sector that will likely feel the sting from consumers tightening their belts), sales and profitability for the firm could be under pressure over the near term. Further, food and fuel costs have been elevated and show no signs of materially abating.

Close Competitors	TTM Sales $Mil	Market Cap $Mil
Sysco Corporation	**37,904**	**11,920**
US FOODSERVICE:USA	NA	NA
PERFORMANCE FOOD GROUP:USA	NA	NA

* Morningstar Analyst Report Available

Data as of

- Higher energy prices, which affect packaging and distribution costs for Sysco, will most likely be a major head wind for food-service distributors.
- The food-service industry is not recession-proof. Subsequently, as economic trends deteriorate, Sysco could be hurt by a prolonged slowdown in sales to its customers.
- Sysco is already feeling the effects of the recent consumer downturn, as volumes in its first fiscal quarter fell about 3% over the prior year's quarter.

Strategy

Strategically, Sysco is attempting to expand its business through the addition of new customers, further penetration of existing accounts, and acquisitions. Beyond this, Sysco is focused on lowering its procurement and delivery costs, as well as the costs of its customer base. One of the firm's current initiatives in line with these efforts is to build several redistribution centers to lower inventory levels and cost of goods sold.

Management & Stewardship

With more than 25 years at Sysco, we believe CEO and chairman Richard Schneider's experience is a huge asset to this food-service distributor, particularly given the more challenging economic environment the firm is currently facing. In our opinion, executive compensation appears reasonable, with about 80% to 90% of management's annual pay based on the firm's performance. We further commend Sysco's executive management for taking a 5% reduction in its base pay in 2008, in light of the challenging economic environment. We believe this is a strong signal to the rest of its managers how committed the firm is to maintaining strict expense control. That said, there are a few areas of the firm's corporate governance that we believe could be improved. For one, we'd like to see directors elected on an annual basis, rather than the current three-year staggered structure. In addition, we believe that the positions of chairman and CEO should be split between two individuals. Finally, four of the 11 directors have served on Sysco's board for more than a decade. Tenures of this length tend to create too cozy a relationship with management, in our view.

Profile

Sysco operates as the largest food-service distributor in North America, controlling about 15% of the market. The firm distributes more than 300,000 food and nonfood products to 400,000 diverse customers, including restaurants, health-care and educational facilities, and lodging establishments. From its founding in 1969 through the end of its 2008 fiscal year, Sysco has acquired around 145 companies or divisions of companies to expand its footprint.

Growth

Although Sysco has produced 7% annual sales growth on average over the past five years, we expect that weakening economic trends and slowing restaurant traffic will result in decelerating sales growth over the next couple of years.

Profitability

Despite the high-level of fixed costs inherent in the food-service industry, Sysco has consistently generated above-average returns on invested capital as it has leveraged the economies of scale of its expansive distribution network.

Financial Health

Sysco's nearly $2 billion of long-term debt (about 35% of total capital) is not a major concern of ours. We believe the firm's ability to service its debt remains in tact, as EBIT covers its interest expense about 19 times.

Authors can be reached at analyst feedback.
